Should I stay or should I go?

May 23rd, 2018

Andrew Pease,

A strong start for markets in January was quickly replaced by uncertainty and volatility, which continue to this day. How might the rest of the year play out? Today Andrew Pease, Global Head of Investment Strategy, looks back over the year so far and discusses the January effect.

"So goes January, so goes the year"

The S&P 500® Index started the year with a bang, rising 5.6% for the largest January gain in 20 years.[1] An old market saying is: "So goes January, so goes the year." In the past 50 years, there have been nine other instances of January gains greater than 5%. In eight of those years, the calendar year gains averaged 26%.[2] The exception was 1987, and we all know what happened that year…

The January effect

Will the *January effect* hold true this year? This year's January euphoria has quickly given way to uncertainty and volatility. Inflation fears, U.S. Federal Reserve (The Fed) tightening and the threat of a trade war have cast a shadow over investor sentiment. On the other hand, U.S. tax cuts and fiscal stimulus are supporting economic growth and corporate earnings.

The bullish case

- Markets usually peak around six months prior to a recession, and in the last 50 years have never peaked more than 12 months before a recession (although the 1987 bear market was outside of a recession).[3]
- Our models and analysis place low odds on a recession before late 2019. A January 2018 peak in the S&P500 is too early under this scenario.

- Global economic growth and corporate earnings are still robust.
- The Fed isn't restrictive yet. Monetary policy is becoming less accommodative, but the Fed hasn't lifted interest rates by enough to be a brake on the economy.

The bear-market case

- The U.S. equity market is very expensive. The CAPE Shiller price-to-earnings ratio is over 31 and higher than before the 1929 market crash.[4] The market was more expensive only during the tech bubble of the late 1990s.
- Expectations for economic growth and corporate earnings are very high. Investors are more likely to be disappointed than surprised going forward.
- U.S. inflation is gradually picking up, which will make the Fed a bigger headwind for markets.
- The trade war between the U.S. and China could escalate and send the global economy into a downturn.

Cycle, Value and Sentiment

A robust investment decision making process

At Russell Investments, we're guided by our cycle, value and sentiment (CVS) investment decision-making process:

Cycle tracks the medium-term forces driving the market. **Today, we score this as modestly positive**, given the strength in global earnings and relatively low near-term recession risks.

Valuation is an excellent predictor of long-term returns and a short-term indicator of risk. We believe long-term returns are likely to be modest. **We score current equity valuations as high**, which means the market is very sensitive to negative news, hence the rise in volatility.

Sentiment captures the short-term battle between fear and greed. Euphoria was taking hold in January and markets were very overbought. The subsequent correction has shaken confidence, but has not sent sentiment towards panic, which would be a contrarian buy signal. **We score sentiment as neutral to slightly positive**, given the upward momentum trend.

Market myth

The *January effect* is more market myth than reality—there's no fundamental reason why a strong start should drive the outcome for the year. Cycle and sentiment suggest the market can push higher, but expensive value hangs over the outlook. Be prepared for volatility, watch the cycle fundamentals, be concerned when investors turn euphoric and look to lean in when pessimism takes hold. That's what we will be doing.

Related posts

Multi-Asset: Why we use derivatives to manage risk Did active management hold up during first-quarter volatility? Confessions of a portfolio manager - #2

Andrew Pease – Global Head of Investment Strategy

[1] Source: https://www.cnbc.com/2018/02/01/best-january-since-1997-bodes-well-for-the-rest-of-the-year.html [2] Source: https://www.thestreet.com/story/14469889/1/stock-market-s-strong-january-performance-bodes-well-for-the-rest-of-the-year.html [3]

Source: http://time.com/money/5070042/3-ways-the-stock-market-could-tank-according-to-experts/ [4] Source: http://www.multpl.com/shiller-pe/Yale Professor Robert Shiller calculates a Cyclically Adjusted P/E Ratio based on stock price divided by prior 10-year earnings. U.S. stock market is represented by an index created by Professor Shiller. The stocks included are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ. Prior to 1926 his data source was Cowles and Associates Common Stocks Index, after 1926 his source has been S&P.

Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly. Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment. Average drawdown is the percentage return from period start date to the market trough within the subsequent three years.

Read this post on our blog: http://wire.russellinvestments.com/2018/05/23/should-stay-or-go-stock-market/